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No.

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTION PRESENTED

Taxes and tax penalties that arise after the date of a bankruptcy filing are "administrative expenses" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(B) and (C). As "administrative expenses," such taxes and tax penalties are entitled to first priority in the distribution of the estate. 11 U.S.C. 507(a)(1). This case presents the following question:

Whether the statutory priority that Congress conferred on the government's claim for post-petition tax penalties may—under the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1)—be subordinated to the claims of general unsecured creditors solely because a court determines that it would enhance "fairness" and "justice" to pay the general creditors first.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-20a) is reported at 48 F.3d 210. The opinion of the district court (App., *infra*, 26a-33a) is unreported. The opinion of the bankruptcy court (App., *infra*, 34a-55a) is reported at 148 B.R. 332.

JURISDICTION

The judgment of the court of appeals was filed on March 2, 1995 (App., *infra*, 23a). A petition for rehearing was denied on June 16, 1995 (App., *infra*, 24a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a), are reproduced in the Appendix, *infra*, at 56a-58a.

STATEMENT

1. In 1986, First Truck Lines, Inc., filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and continued to operate its business as debtor-in-possession. During the following two years, the debtor failed to pay the social security and unemployment taxes accruing from its operations. After efforts to reorganize the debtor proved unsuccessful, the bankruptcy case was converted to a Chapter 7 liquidation in 1988. Respondent was appointed trustee at that time (App., *infra*, 2a).

The Internal Revenue Service filed a request for payment of the taxes, interest and tax penalties that accrued after the filing of the bankruptcy petition. Respondent stipulated that the unpaid postpetition taxes and interest are "administrative expenses" that are entitled to first priority in the distribution of the assets of the estate under Section 507(a)(1) of the Bankruptcy Code, 11 U.S.C. 507(a)(1). Respondent asserted, however, that postpetition tax penalties are

not entitled to priority in distribution. The parties applied to the bankruptcy court for resolution of that dispute (App., *infra*, 2a-3a).

2. The bankruptcy court acknowledged (App., *infra*, 40a) that Section 503(b)(1)(C) of the Bankruptcy Code expressly defines postpetition tax penalties to be "administrative expenses" (11 U.S.C. 507(a)(1)). The court observed, however, that Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1), provides that a court may (*ibid.*),

> under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *.

Because Section 510(c)(1) "does not expressly define the phrase 'equitable subordination,'" the court stated that it would "resort to an examination of the legislative history" (App., *infra*, 42a-43a).

At the time the Bankruptcy Code was enacted in 1978, the floor statement of the House sponsor stated (App., *infra*, 43a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards), and citing 124 Cong. Rec. 33,992, 33,998 (1978) (Sen. DeConcini) (emphasis added by court)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

The bankruptcy court concluded that this legislative history evidences that Congress intended that a tax "penalty"—like any other "penalty"—would be "susceptible to subordination" under the "principles of equitable subordination" codified in Section 510(c) of the Code (App., *infra*, 43a). The court deemed it irrelevant that in 1978 Congress provided a specific statutory priority for postpetition tax "penalties" (11 U.S.C. 503(b)(1)(C)). The court also found it irrelevant that the United States had not been "guilty of inequitable conduct" in asserting its claim. The court concluded that the government's claim for tax penalties is subject to equitable subordination simply because it is designed to enforce a "penalty" (App., *infra*, 44a).

In applying the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, the court stated that its task is to "weigh the equities of the various claims on a case-by-case basis" to determine whether subordination is appropriate (App., *infra*, 44a). The court began its "weighing" or "balancing" of "the equities" by distinguishing between the pecuniary losses incurred by general commercial creditors and the nonpecuniary loss represented by statutory tax penalties. Finding that the Bankruptcy Code contains a "preference for compensating actual loss claims," the court held "that the equities tilt in favor of subordinating the postpetition nonpecuniary loss tax penalties sought by the IRS" to "the claims of general unsecured creditors of the debtor" (*id.* at 49a-50a). Otherwise, the court noted, the assets available for payment of the general unsecured creditors would be reduced by the amount of the tax penalties that, by statute, were given first

priority in distribution as administrative expenses of the estate (*ibid.*).

3. The district court affirmed (App., *infra*, 26a-33a). The court stated that all types of priority claims—including first priority claims for administrative expenses—may be subordinated under the "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code (App., *infra*, 29a). The court agreed with the bankruptcy court that the "principles of equitable subordination" are not restricted to remedying inequitable misconduct by creditors. The court held, instead, that the "principles of equitable subordination" permit a tax "penalty" to be subordinated solely in order to promote the priority of the claims of other creditors who suffered pecuniary losses from their dealings with the estate (*id.* at 32a-33a).

The district court emphasized that "other creditors * * * provided value to [the debtor] and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it" (App., *infra*, 33a). For this reason, the court concluded that "the equities tip in favor of subordinating the IRS's claim for tax penalties in this case" (*ibid.*).

4. a. The court of appeals affirmed (App., *infra*, 1a-20a). The court noted that this Court has applied "principles of equitable subordination" in bankruptcy cases only in situations involving "creditor misconduct" (App., *infra*, 5a, citing *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper* v. *Litton*, 308 U.S. 295 (1939); *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court also noted that, in *United States*

v. *Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied, 502 U.S. 1092 (1992), another panel of that circuit held that the government's claim for prepetition excise tax liabilities—which have *seventh* priority in distribution under Section 507(a)(7) of the Bankruptcy Code—is *not* subject to equitable subordination solely in order to improve the "fairness" of the distribution to other creditors (App., *infra*, 5a-6a). The court held, however, that none of these decisions is controlling in the context of this case, which concerns the application of "principles of equitable subordination" to a tax "penalty" (*id.* at 6a).

The court of appeals followed the analysis of the bankruptcy court in concluding that the legislative history of Section 510(c) indicates that a statutory "penalty" is properly subject to equitable subordination. The court noted that the floor statement of the House sponsor of the 1978 Bankruptcy Reform Act reflected that Congress intended to "follow existing case law and leave to the courts development of this principle" (App., *infra*, 11a, quoting 124 Cong. Rec. at 32,398 (Rep. Edwards)). The court acknowledged that there was no "existing case law" as of 1978 that supported the equitable subordination of priority tax penalty claims. The court ascribed this, however, to the fact that, "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (App., *infra*, 12a). The court noted that three more recent decisions have held that claims for *pre*petition *non*priority tax penalties may be equitably subordinated even though no governmental misconduct occurred (*id.* at 14a, citing *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990), *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990), and *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990)). The court stated that the reasoning of those decisions applied directly to this case (App., *infra*, 19a):

> We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

b. Judge Batchelder filed a concurring opinion (App., *infra*, 21a-22a). She stated that the court had correctly determined that the "principles of equitable subordination" permit subordination of priority tax claims. In her view, the plain language

of the statute mandates that conclusion and "nothing requires us to delve into the legislative history" (*id.* at 22a):

> Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

REASONS FOR GRANTING THE PETITION

The court of appeals held in this case that postpetition tax penalties are not to be given the *first* priority that Congress expressly provided for such claims in Sections 503(b)(1)(C) and 507(a)(7) of the Bankruptcy Code. The court held that claims for such penalties are instead to be denied *any* priority and are to be subordinated to general unsecured claims against the debtor. The court stated that its conclusion results from application of the judge-made "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code.

By holding that a tax "penalty" is to be subordinated to all other claims, the decision in this case annuls and reverses the precisely opposite set of statutory priorities that Congress enacted. The decision thereby conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975)). The doctrine of equitable subordination does not confer a power of statutory nullification on the bankruptcy courts. Instead,

as this Court's decisions reflect, the doctrine has a far narrower and more appropriate role. Its function is to deter "conduct either in acquiring or asserting the claim which is itself inequitable" (*ibid.*). That traditional rationale obviously would not justify subordination of the tax penalty claims in this case.

By assuming a broad authority to realign statutory priorities based upon a "weighing" or "balancing" of the "equities," the court of appeals has seriously misapplied the judge-made doctrine of "equitable subordination" and unloosened that doctrine from its proper moorings. If courts are permitted to determine, on a case-by-case analysis of the "balance of the equities," whose claims are to be paid first and whose are to be paid last, the carefully constructed scheme of priorities established in the Bankruptcy Code would be made superfluous.

The decision in this case has broad recurring significance. The conclusion that a prescribed tax penalty is to be subordinated to all other claims against the debtor has obvious significance for tax enforcement. Indeed, as this Court recognized in *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966), Congress enacted the priority for postpetition tax penalties precisely because such penalties are an important and necessary measure for ensuring tax compliance in bankruptcy cases.

The court's rationale that, because tax penalty claims do not compensate for pecuniary loss, they should be equitably subordinated to the claims of "creditors who suffered actual losses," as a matter of "fairness" (App., *infra*, 19a), places in question not merely the priority of tax penalties. It will spawn litigation over whether claims for other types

of governmental penalties, punitive damages, liquidated damages and other non-compensatory damages may be "equitably" subordinated simply because those claims do not involve an outlay of funds that extended "value to the debtor" (*ibid.*).

Because the courts of appeals are in conflict in their understanding and application of the judge-made doctrine of "equitable subordination," and because of the importance of the issue presented, review by this Court of the decision in this case is warranted.[1]

1. a. A postpetition tax penalty is defined by statute to be an "administrative expense" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(C). As an "administrative expense," such a penalty has "[f]irst" priority in the distribution of the assets of the estate. 11 U.S.C. 507(a)(1). See also 11 U.S.C. 726(a)(1).

The priorities that Congress established in the Bankruptcy Code apply "[e]xcept as provided in section 510" of the Code. 11 U.S.C. 726(a). Section 510 authorizes only three specific exceptions to the statutory ordering of priorities. First, any claim may be subordinated by agreement. 11 U.S.C. 510(a). Second, claims seeking rescission or damages from sales of the debtor's securities may be subordinated. 11 U.S.C. 510(b). Third, any claim may be subordinated to any other claim "under principles of equitable subordination * * *." 11 U.S.C. 510(c). The question presented in this case is thus not whether "principles of equitable subordination" *may* be applied to priority claims; instead, it is *what* those principles are and *how* they are to be applied to priority claims.

[1] The United States is concurrently filing a petition for a writ of certiorari to review the decision of the Tenth Circuit in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (1995), which presents issues closely related to those of the present case. If, as we urge, both petitions are granted, we suggest that the two cases be set for argument in tandem.

We have furnished a copy of the petition in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.* to counsel for respondents in this case. We have also furnished a copy of the petition in this case to counsel for respondents in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*

b. The judge-made doctrine of equitable subordination has a clear origin and a limited scope (*In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941)):

> [A] court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims.

See also *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 788 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The issue that is to be resolved "under principles of equitable subordination" is whether (2 Collier Bankruptcy Manual ¶ 510.01[1], at 510-2 (3d ed. 1995)):

> harmful conduct [of the claimant] was directed at other creditors. If it was, the claim which is otherwise provable and allowable should be postponed until the claims of the creditors, who were harmed, have been satisfied.

See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); *Taylor* v. *Standard Gas & Electric*

Co., 306 U.S. 307, 323 (1939); Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 85 (1961).

The doctrine of equitable subordination thus provides a means to redress harmful misconduct of an individual claimant.[2] The doctrine does not, however, authorize a court to disregard statutory priorities merely because the court concludes that it would be more "fair"—or would somehow be better policy—to adopt a different distribution scheme. "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988). As the Ninth Circuit explained in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787:

> [I]t is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally proper but unconscionable applications of legal rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching.

See also *In re Columbia Ribbon Co.*, 117 F.2d at 1002.[3]

In enacting the statutory priority scheme, Congress itself made a "reasonable classification of claims as entitled to priority because of superior equities" (*Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940)). The categorical balancing of equities that Congress made in adopting the Code's priority provisions may not categorically be displaced by the courts under the guise of "equitable subordination." As the Ninth Circuit stated in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788, the doctrine of equitable subordination does not permit a court to say, "in effect * * *, 'No, the distribution scheme provided by the [Bankruptcy] Act is a mistake * * *.'"

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[2] The underlying premise of any application of the doctrine of "equitable subordination" to "creditor misconduct" is that Congress has measured the equities of competing classes of claims but has not measured the conduct of the individual creditors who assert those claims. See *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940). Because Congress did not (and indeed cannot) take the conduct of individual creditors into account in enacting a bankruptcy distribution scheme, subordination of a particular claim based upon the inequitable conduct of the specific creditor does not contravene the legislative judgment concerning the relative equities of the various classes of claims in general. See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787.

[3] Similarly, in *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), the Court rejected the assertion that a statutory priority for state taxes should not be recognized because it created an "injustice" for other creditors and gave the State an undue "advantage" (*id.* at 490):

> [C]onsiderations of this character, however properly addressed to the legislative branch of the government, can have no place in influencing judicial determination. It is the province of the court to enforce, not to make the laws, and if the law works inequality the redress, if any, must be had from Congress.

The decision in the present case ultimately reflects an implicit policy judgment by the courts below that Congress somehow erred or acted "unfairly" in awarding first priority to the government's claims for postpetition tax penalties under Section 503(b)(1)(C) and Section 507(a)(1).[4] Even if there were a basis to believe that it might be more "fair" to pay other creditors before postpetition tax penalties are paid, any dispute about the relative merits of alternative priority schemes is simply irrelevant to the task that the court of appeals properly had before it. Congress authoritatively resolved that policy issue when it expressly provided a first priority for postpetition tax penalty claims in 11 U.S.C. 503(b)(1)(C). As this Court explained in enforcing the priority for postpetition tax penalties in *Nicholas* v. *United States*, 384 U.S. at 694, Congress adopted that priority precisely because penalties are an important and "legitimate means to enforce" compliance with the tax laws in bankruptcy cases. See also *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[5] By in-

[4] While Section 726(a)(1) preserves first priority in distribution for postpetition tax penalties, Section 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims. Compare 11 U.S.C. 726(a)(1) with 11 U.S.C. 726(a)(4). The reasoning adopted by the courts below is thus invalid for the additional reason that it deprives the carefully crafted distinctions made by Congress in enacting Section 726 of any force.

[5] The court of appeals erred in relying on the suggestion of Representative Edwards that "existing case law" permits subordination of "a claim * * * of a status susceptible to subordination, such as a penalty * * *" (App., *infra*, 11a). Whatever "penalty" Representative Edwards may have had in mind in making that assertion, he obviously was not

voking "equitable subordination" as authority for annulling the categorical priorities that Congress enacted, the decision in this case conflicts with the deci-

contemplating that postpetition tax penalty claims would be subordinated under Section 510(c)(1) when Section 503(b)(1)(C) of the *same* Act provides "[f]irst" priority for such claims. See 11 U.S.C. 503(b)(1)(C). Indeed, Representative Edwards went on to say in the next portion of his remarks (124 Cong. Rec. at 32,416c):

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill.

See also 124 Cong. Rec. 33,998, 34,016 (1978) (Sen. DeConcini).

It is also apparent that, in suggesting that "penalty" claims are subject to subordination, the floor statement of Representative Edwards did not accurately describe "existing case law." Neither prepetition nor postpetition governmental penalties were subordinated under "existing case law" in 1978. Claims for prepetition penalties were disallowed (not subordinated) under Bankruptcy Act § 57j, 11 U.S.C. 93(j) (1976). See *Simonson* v. *Granquist*, 369 U.S. 38, 40 (1962). Claims for *post*petition penalties incurred by the trustee or debtor-in-possession were allowable, however, and were entitled to first priority in distribution of the bankruptcy estate. *Nicholas* v. *United States*, 384 U.S. 678, 692-695 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939); *United States* v. *New York Creditmen's Adjustment Bureau, Inc.*, 394 F.2d 340, 341-342 (2d Cir. 1968).

The majority and concurring opinions in this case (App., *infra*, 12a-13a, 22a) thus erred in stating, without qualification, that penalty claims were disallowed under the former Bankruptcy Act. There also was no "existing case law" subordinating or disallowing postpetition penalty claims based upon their "status." See *Burden* v. *United States*, 917 F.2d 115, 123 (3d Cir. 1990) (Alito, J., concurring in part and

sion of the Ninth Circuit in *Stebbins* and with the long line of cases holding that "[d]ecisions about the treatment of *categories* of claims in bankruptcy proceedings * * * are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination * * *." *Burden* v. *United States*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part; emphasis added).[6] See, *e.g.*, *Benjamin* v. *Diamond*, 563 F.2d 693, 700

dissenting in part). Any misdescription of "existing case law" contained in the 1978 floor statement of Representative Edwards obviously could not alter the "principles of equitable subordination" that the courts had developed and that are to be applied under Section 510(c)(1).

[6] The Third Circuit has placed itself on both sides of this issue. In 1941, the court explained that the doctrine of equitable subordination does not authorize a court to adopt a priority scheme different from the statutory scheme based simply upon the court's "theory of equity." *In re Columbia Ribbon Co.*, 117 F.2d at 1002. Instead, the court explained, equitable subordination may be applied to "disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims." *Ibid.*

In 1990, the Third Circuit acknowledged that "prior to the enactment of the Bankruptcy Act of 1978," the doctrine of equitable subordination had applied "only when there has been a showing of bad faith on the part of the creditor." *Burden* v. *United States*, 917 F.2d at 119. The court identified nothing in the text or history of the 1978 legislation to justify a departure from that historical understanding of equitable subordination. The court stated, however, that it was "persuaded" by several recent decisions holding that "creditor misconduct is not a prerequisite for equitable subordination."

(5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *In re Credit Industrial Corp.*, 366 F.2d 402, 408 (2d Cir. 1966); *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir. 1941) (reversing "equitable subordination" of a claim for taxes, for "[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence").

c. In 1978, Congress codified the judge-made doctrine of equitable subordination as Section 510(c)(1) of the Bankruptcy Code. That provision states that bankruptcy courts may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *." 11 U.S.C. 510(c)(1).

That statute did not enlarge the authority that courts had previously exercised. As the 1978 floor statement quoted by the court of appeals emphasizes, Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle" (App., *infra*, 11a, quoting 124 Cong. Rec. 32,398 (Rep. Edwards)).

The emphasis in the 1978 floor statement that "existing case law" is to be followed in applying "principles of equitable subordination" reflects a deliberate policy determination that Congress made at that time. In enacting the 1978 Act, Congress con-

Id. at 120-121. As described in the text, Judge Alito dissented from that part of the court's opinion.

sidered and rejected statutory language that would have granted bankruptcy courts authority to subordinate claims on much broader grounds. The bill that first passed the House of Representatives contained a version of Section 510(c) that would have allowed any claim to be subordinated simply "on equitable grounds." H.R. 8200, 95th Cong., 1st Sess., § 510 (1977). The report accompanying the House bill emphasized that this language differed from the existing doctrine of equitable subordination, for it would permit the courts to order "subordination on any equitable grounds." H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977). The broad language of the House bill was deleted, however, from the final legislation. The phrase "under principles of equitable subordination" was substituted in its place. See S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978); 124 Cong. Rec. 32,416 (1978) (Rep. Edwards); 124 Cong. Rec. 34,016 (1978) (Sen DeConcini).

The history of Section 510(c) thus reflects that Congress consciously elected to adopt only the "existing" principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts. In the present case, however, the court of appeals declined to follow the "existing case law" that had squarely held that "equitable subordination" may not be applied categorically to reorder statutory priorities. By refusing to apply that "existing case law," the court of appeals placed itself in conflict with the decisions of the Fifth and Ninth Circuits in *Benjamin* v. *Diamond* and *Stebbins* v. *Crocker Citizens National Bank*. See also *In re Credit Industrial Corp.*, 366 F.2d at 408; 3 *Collier on Bankruptcy*

¶ 510.01 (15th ed. 1995) ("The law in this area is of long standing, having been judicially created").

d. The conflict among the courts of appeals concerning the proper scope of the doctrine of equitable subordination has recently become pronounced. In conflict with the decisions of the Fifth Circuit in *Benjamin* and the Ninth Circuit in *Stebbins*—as well as the earlier decisions of the Third Circuit in *In re Columbia Ribbon Co.* and the Eighth Circuit in *Killoren*—the Third, Seventh, Eighth and Tenth Circuits have joined the Sixth Circuit in holding that "principles of equitable subordination" are *not* confined to remedying creditor misconduct and instead permit courts categorically to subordinate "penalty" claims to the claims of other creditors who have incurred an "actual loss" (App., *infra*, 20a). See *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990); *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155, 1158 (10th Cir. 1995).[7]

[7] These cases from the Third, Seventh, Eighth and Tenth Circuits all involve the subordination of nonpriority tax penalty claims in cases under Chapters 11 and 13, rather than Chapter 7, of the Bankruptcy Code. As we have noted (note 4, *supra*), in Chapter 7 cases, Congress expressly provided priority for postpetition tax penalty claims and subordinated only prepetition tax penalty claims. Compare 11 U.S.C. 726(a)(4). No similar provision subordinates prepetition penalty claims in cases under other chapters. Indeed, Congress rejected proposals that would have required subordination of prepetition tax penalty claims in cases under all chapters. See *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973).

These courts, like the Sixth Circuit in this case, concluded that equitable subordination of a tax penalty claim is appropriate to ensure that payment of the penalty does not reduce the assets available for other claims.

In so holding, these courts acknowledged that, prior to enactment of the Bankruptcy Code in 1978, the "existing case law" had held that the doctrine of equitable subordination requires a showing of creditor misconduct. See, *e.g.*, *In re Virtual Network Services Corp.*, 902 F.2d at 1248, citing *Pepper* v. *Litton*, 308 U.S. at 304-305. The courts also recognized that Congress intended such "existing case law" to apply in any future elaboration of the "principles of equitable subordination" (902 F.2d at 1248; App., *infra*, 11a). They reasoned, however, that the history of the 1978 Act indicates that such older authority is not necessarily binding because "Congress intended courts to continue developing the principles of equitable subordination." *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1158, citing *In re Virtual Network Services Corp.*, 902 F.2d at 1249-1250.

As evidence of the "developing" principles of equitable subordination, the courts noted that, in *In re Stirling Homex Corp.*, 579 F.2d 206 (1978), the Second Circuit held that the claims of shareholders who alleged that they were defrauded in purchasing stock of the debtor should be equitably subordinated—even in the absence of any creditor misconduct.[8] The courts

[8] *In re Stirling Homex Corp.* involved an attempt by equity shareholders who allegedly were defrauded in the purchase of the debtor's securities to *elevate* their priority in the corporate bankruptcy from last priority (as equity holders) to that of unsecured creditors (as tort claimants). The court subordinated the shareholders' claims to the claims of general unsecured creditors because "the equities favor the conventional general unsecured creditors rather than the allegedly defrauded stockholders." 579 F.2d at 213.

The decision in *Stirling Homex* did not constitute a startling departure from the "existing case law," as some of the courts of appeals have assumed. Instead, that decision appears to represent an application of a settled rule described in the prior decision of the Second Circuit in *In re Credit Industrial Corp.*, 366 F.2d at 408-409 (emphasis added):

> Equitable subordination, which is founded upon estoppel, is the doctrine invoked by courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, *or a special position which they occupy vis-a-vis the bankrupt that justifies subordination of their claims.*

That particular application of the principles of equitable subordination can be traced to this Court's decision in *Pepper* v. *Litton*, 308 U.S. 295 (1939). See *In re Credit Industrial Corp.*, 366 F.2d at 409.

Nothing in *Stirling Homex* provides support for the proposition that courts may apply "equitable subordination" categorically to annul the priority classification schemes that Congress enacted. Indeed, the rule that the Second Circuit applied to shareholder claims in *Stirling Homex* was codified in 1978 as subsection Section 510(b) of the Bankruptcy Code (11 U.S.C. 510(b)), which the 1978 floor statement of Representative Edwards described as an example of "existing case law." See App., *infra*, 11a.

concluded that, under this "developing" principle (but see note 8, *supra*), equitable subordination should be based on a "case-by-case" evaluation of the equities and should no longer require proof of creditor misconduct (*United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1159, quoting

In re Virtual Network Services Corp., 902 F.2d at 1250):

> [Section] 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

In the absence of creditor misconduct, however, the doctrine of equitable subordination does not authorize the "case-by-case" balancing of equities that these courts have upheld. In particular, equitable subordination does not authorize judicial disregard of the categorical priorities that Congress has enacted; nor does it authorize judicial nullification of the statutory priority scheme. By reaching the opposite conclusion in this case, the decision of the court of appeals has enlarged the developing conflict and has ignored the inherent limitations of any court sitting in "equity." See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787: ([T]he chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule.).

3. The proper scope of the doctrine of equitable subordination is a matter of substantial recurring importance. The decision in this case has significance not only for the enforcement of federal, state and local tax laws but also for the enforcement of many other types of governmental programs. For example, under the rationale applied by the court of appeals

in this case, penalties designed to enforce federal and state health and safety regulations presumably would also be subject to "equitable subordination" to the claims of the general unsecured creditors who incurred an "actual loss" in their dealings with the estate (App., *infra*, 20a).

Commentators have further noted that the "case-by-case" evaluation of the "equities" of each claimant that these decisions authorize creates harmful uncertainties for private creditors as well. The unfettered equitable authority assumed in these decisions has threatened "the financial community [by calling] into question the future of bankruptcy priority." See Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993).[9]

By effectively ensuring that claims for postpetition penalties will not be paid from the assets of bankruptcy estates, the decision in this case would allow debtors-in-possession to disregard their legal obligations with impunity.[10] Allowing violations of the law

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[9] Under a case-by-case evaluation of the "equities" of each competing, innocent claim, it is not possible to be certain whether, for example, claims for punitive damages would be regarded as "inequitable" (because not involving "actual losses") or "equitable" (because designed to promote the public purpose of deterring malicious behavior). See *In re Colin*, 44 B.R. 806, 810 (Bankr. S.D.N.Y. 1984).

[10] The court of appeals erred in suggesting (App., *infra*, 19a) that the tax penalties involved in this case can be collected by the government even if that claim is subordinated in the liquidation proceedings. The court reasoned that ultimate collection is assured because the "debtor in possession remains liable individually for the postpetition tax penalties"

to go unsanctioned—and undeterred—is neither "fair," nor "equitable," nor good "policy." As this Court recognized in *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939), and *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966), the priority for postpetition penalties in bankruptcy exists for the very purposes of ensuring that debtors abide by the same rules of law that apply to every other business. See also *United States Department of Interior* v. *Elliott*, 761 F.2d 168, 171 (4th Cir. 1985).[11] In any event, as we have noted and as other circuits have held, the doctrine of equitable subordination does not authorize a "reweighing" of the balance of equities that Congress itself struck in providing the statutory priority for postpetition tax penalty claims.

(*ibid.*). In making that statement, however, the court seems to have forgotten that this case involves a liquidation under Chapter 7. After such a liquidation, the debtor will have no assets available to pay any unsatisfied, subordinated tax penalty claim.

[11] In *United States Dep't of Interior* v. *Elliott*, the court explained why priority is granted to claims for postpetition penalties even though such claims may deplete the assets available to other creditors. Creditors may influence the debtor in possession or trustee to prevent the accrual of such penalties and should not be permitted to benefit from the false economies recognized by the estate through its failure to comply with applicable nonbankruptcy law. 761 F.2d at 171.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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AUGUST 1995

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 93-4311

IN RE: FIRST TRUCK LINES, INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

THOMAS R. NOLAND, Trustee, APPELLEE

On Appeal from the United States District Court
for the Southern District of Ohio

Decided and Filed March 2, 1995

Before: MARTIN and BATCHELDER, Circuit Judges; and ENSLEN, District Judge.*

MARTIN, J., delivered the opinion of the court, in which ENSLEN, D.J., joined. BATCHELDER, J. (pp. 18-19), delivered a separate concurring opinion.

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* The Honorable Richard A. Enslen, United States District Judge for the Western District of Michigan, sitting by designation.

BOYCE F. MARTIN, JR., Circuit Judge. We have before us an appeal of the bankruptcy court's decision to equitably subordinate the Commissioner of Internal Revenue Service's claim for postpetition, nonpecuniary loss tax penalties to the claims of general unsecured creditors. For the following reasons we affirm the decision of the district court.

The debtor in this case, First Truck Lines, Inc., voluntarily filed for relief under Chapter 11 of the Bankruptcy Code on April 10, 1986. During the postpetition operation of its business, the debtor-in-possession did not pay to the Internal Revenue Service accrued Federal Insurance Contributions Act and Federal Unemployment Tax Act taxes. In June 1988, the debtor moved to convert the case to a Chapter 7 bankruptcy, and the bankruptcy court ordered conversion on August 1, 1988. Thomas R. Noland was appointed the Trustee. The debtor ceased operations thereafter, and liquidation of the estate assets did not produce sufficient funds to pay all creditors in full. The bar date for filing claims under Chapter 7 was December 1, 1988.

On November 22, 1988, the Internal Revenue Service filed a "Request for Payment of Administrative Expenses" claim ("Claim 102"). Claim 102 was comprised of accrued postpetition, preconversion taxes, interest, and penalties. On April 20, 1989, the Internal Revenue Service filed an additional "Request for Payment of Administrative Expenses" claim ("Claim 107"), amending Claim 102. The bankruptcy court permitted Claim 107 to partially amend Claim 102, adding a penalty for postpetition, unpaid Federal Unemployment Tax Act taxes.

Once litigation commenced, the Commissioner and the Trustee stipulated that the tax and interest portion of Claim 102, but not the tax penalty portion, were administrative expenses with priority under 11 U.S.C. §§ 726(a)(1), 507 (a)(1), and 503(b)(1) (1988). We take this stipulation to mean that all taxes and interest were in fact given a priority in the bankruptcy estate. The issue before the bankruptcy court, then, was whether administrative expense priority should be accorded to the postpetition tax penalties. The bankruptcy court held that, although postpetition tax, interest, *and penalties* were "administrative expenses" pursuant to 11 U.S.C. § 503 (b), the tax penalties were subject to the court's equitable subordination powers under 11 U.S.C. § 510(c) (1988). The court then interpreted and applied its powers of equitable subordination to include the ability to subordinate a claim, not only in the case of creditor misconduct, but also in the case of postpetition, nonpecuniary loss tax penalties. In balancing the equities, the bankruptcy court reasoned that the Bankruptcy Code exhibited a preference for compensating actual losses, especially in a liquidation proceeding. Furthermore, the bankruptcy court reasoned that, unlike business creditors who had surrendered a valuable asset to the debtor, the United States had not suffered an actual pecuniary loss with regard to the penalties. The bankruptcy court concluded that the equities of the case required subordination of the Commissioner's tax penalty claim to the claims of general unsecured creditors. The district court agreed.

The central issue in this appeal is whether a bankruptcy court may, in a Chapter 7 case, equitably subordinate postpetition, nonpecuniary loss tax penalties to any other claim, including the claims of general unsecured creditors, in the absence of creditor mis-

conduct: here, in the absence of misconduct by the Commissioner. No other Circuit has addressed this precise issue, although three other Circuits have determined that *prepetition*, nonpecuniary loss tax penalty claims could be equitably subordinated even in the absence of creditor misconduct. *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990) (Chapter 13 case); *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990) (liquidating Chapter 11 case); *In re Virtual Network Servs. Corp.*, 902 F.2d 1246 (7th Cir. 1990) (liquidating Chapter 11 case). Should we decide that *postpetition*, nonpecuniary loss tax penalty claims are also subject to equitable subordination in a Chapter 7 case even in the absence of creditor misconduct, we must also decide whether the bankruptcy court properly subordinated the tax penalty claim in this case.

The Commissioner argues that the bankruptcy court does not have the power to equitably subordinate the postpetition tax penalties in Claim 102 to the claims of general unsecured creditors. The Commissioner's primary assertion is that Congress has already balanced the equities with regard to postpetition tax penalty claims in a Chapter 7 case and has expressly awarded administrative expense priority to claims for postpetition taxes, interest *and penalties* under 11 U.S.C. §§ 726(a)(1), 507(a)(1), and 503(b)(1)(B) and (C). The Commissioner contends that Congress was well aware that tax penalties, by their nature, are not related to the giving of value to the debtor. Thus, knowing that the only colorable argument that can be made for equitably subordinating postpetition, nonpecuniary loss tax penalty claims is that it is unfair and unjust to award the government higher priority for a claim

not based on the extension of value to the debtor, Congress still gave tax penalties administrative expense priority. The argument continues that a bankruptcy court may not, based on the same equitable ground, disregard the will of Congress and grant equitable relief to general unsecured creditors by subordinating the tax penalty claim. The Commissioner concludes that the principles of equitable subordination enable a bankruptcy court to subordinate a postpetition tax penalty claim only in the presence of misconduct.

In support of this position, the Commissioner relies on our decision in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 112 S. Ct. 1165 (1992), and on pre-1978 Supreme Court cases permitting equitable subordination of claims because of creditor misconduct. *See Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper v. Litton*, 308 U.S. 295 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939). The Commissioner argues that our decision in *Mansfield Tire* requires us to reverse the district court. The Commissioner construes *Mansfield Tire* as expressly rejecting the proposition that bankruptcy courts may employ equitable subordination to override Congress's priority scheme based on the court's own view of equity. *Id.* at 1062. The view of the Commissioner, while partially correct, constitutes an incomplete understanding of *Mansfield Tire*. This Court also said in *Mansfield Tire* that, while a bankruptcy court may not impose its own view of equity where Congress has set priorities, Section 510(c) expressly permits a bankruptcy court to apply the "principles of equitable subordination" to subordinate a claim "otherwise susceptible to subordination, such as a penalty."

Mansfield Tire, 942 F.2d at 1062 (citing 1978 U.S.C.C.A.N. 5787, 6452 (statement of Rep. Edwards); 1978 U.S.C.C.A.N. 6505, 6521 (statement of Sen. DeConcini)). In *Mansfield Tire*, we decided only whether a claim for an excise tax was the type of claim susceptible to subordination, and not whether a tax penalty claim was susceptible to subordination. As to the Supreme Court cases cited above, these do not address the precise question this Court must answer and do not preclude our holding that equitable subordination may be proper even in the absence of creditor misconduct.

The Trustee and the Commissioner agree that Congress has given postpetition tax penalties first priority as administrative expenses in a Chapter 7 case. 11 U.S.C. §§ 726(a)(1), 507(a)(1), 503(b)(1)(C). This Court, in the case of *In re Flo-Lizer, Inc.*, 916 F.2d 363, 366 (6th Cir. 1990), reached the same conclusion, but we did not discuss the relationship between Section 510(c) and Section 503(b). Although the parties agree as to the priority of postpetition, nonpecuniary loss tax penalty claims, the parties disagree as to the effect of Section 510(c) on the tax penalty claim. The Trustee argues that the statutory treatment of a postpetition tax penalty as an administrative expense does not necessarily mean that the claim cannot be equitably subordinated under Section 510(c). The trustee contends that 11 U.S.C. § 726(a)(1) provides that all Chapter 7 distributions are subject to Section 510(c), and that Section 510(c), in turn, permits equitable subordination in the appropriate case. The Trustee then relies on our opinion in *Mansfield Tire* for the proposition that tax penalties are subject to equitable subordination. *Mansfield Tire*, 942 F.2d at 1062 (distinguishing tax

claims, which are not ordinarily subject to equitable subordination, from penalties, which are). In his brief, the Trustee sums up his position as follows:

> [T]he IRS's argument that equitable subordination ignores Congressional mandates for priority in reality ignores the Congressional mandate under 11 U.S.C. § 726(a) that these priorities are explicitly subject to 11 U.S.C. § 510(c). Equitable subordination of these penalties is not inconsistent with the Bankruptcy Code if the Code itself specifically authorizes it.

Here, we review the decision of the district court deciding questions of statutory interpretation *de novo*. *United States v. Hans*, 921 F.2d 81, 82 (6th Cir. 1990). It is clear that the starting point for our inquiry into the meaning of the statutes at issue is the language used by Congress. *Estate of Floyd Cowart v. Nicklos Drilling Co.*, 112 S. Ct. 2589, 2594 (1992) (citing *Demarest v. Manspeaker*, 498 U.S. 184, 190 (1991)). "[W]hen a statute speaks with clarity to an issue[,] judicial inquiry into the statute's meaning, in all but the most extraordinary circumstances, is finished." *Id.; see also United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989) (observing that "[T]he plain meaning of legislation should be conclusive, except in 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of the drafters.'") (citation omitted). However, when there is an ambiguous term in a statute, or when a term is undefined or its meaning unclear from the context of the statute, it is our duty to examine the legislative history in order to render an interpretation that gives

effect to Congress's intent. In *re Vause*, 886 F.2d 794, 801 (6th Cir. 1989). In this case, the interpretation of the phrase "principles of equitable subordination," found in Section 510(c), is crucial to the outcome of this case and is not defined by statute. Therefore, we must look to legislative history or case law to interpret this phrase.

First, we note, as did the bankruptcy court, that the tax penalty claims here were properly characterized as postpetition administrative expenses pursuant to 11 U.S.C. § 348(d). Section 348(d) states that

> a claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1307, or 1208 of this title, *other than a claim specified in section 503(b) of this title* [administrative expenses], shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition.

(emphasis added). Therefore, the tax penalty claim in this case is a *postpetition* claim—a claim against the estate of the bankrupt—and retains its priority under Section 726(a)(1).

In Chapter 7 cases, Congress gave first priority to postpetition claims for taxes and related penalty claims, as administrative expenses. However, the priority of the tax and penalty claims is specifically subject to Section 510(c) under the terms of Section 726(a). Section 726(a)(1) reads in full:

> (a) *Except as provided in section 510 of this title*, property of the estate shall be distributed—

> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;

(emphasis added). Section 507(a)(1) specifies that certain claims and expenses have priority as administrative expenses. Section 507(a)(1) states:

> (a) The following expenses and claims have priority in the following order:
>
> (1) First, administrative expenses allowed under section 503(b) of this title. . . .

Section 503(b) gives the following expenses and claims first priority status as administrative expenses:

> (b) After notice and a hearing, there shall be allowed, administrative expenses . . . including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;
>
> (B) any tax—
>
> (i) incurred by the estate. . . .
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

Thus, a tax penalty relating to a tax incurred by the estate has first priority. However, Section 726(a)(1) makes the priority subject to Section 510. Subsection 510(c) permits equitable subordination and it reads:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest;

11 U.S.C. § 510(c)(1).

Given "a normal commonsense reading" of the statutes to this point, *United States v. X-citement Video, Inc.*, 63 U.S.L.W. 4019, 4023 (U.S., Nov. 29, 1994) (Stevens, J., concurring), the language used by Congress gives tax penalty claims administrative expense priority *subject to* the bankruptcy court's equity powers. However, as Section 510(c) provides, the court's power may not be exercised arbitrarily, but only pursuant to the principles of equitable subordination. The phrase "principles of equitable subordination" is not, however, defined by the Bankruptcy Code. Thus, in order to comprehend the scope of the bankruptcy court's equitable subordination powers, we look to any relevant case law and at the legislative history to determine what Congress meant by the phrase "principles of equitable subordination."

Both the district court, and the Seventh Circuit in *Virtual Network Services*, examined in detail the legislative history of Section 510(c), as well as the meaning properly accorded that history. We agree with the Seventh Circuit's view that the statements of Representative Edwards and Senator DeConcini provide the most reliable indicia of the legislative intent as to the meaning of the phrase "principles of equitable subordination." We recite here the oft-quoted

passage from identical statements made by Representative Edwards and Senator DeConcini to their respective houses of Congress regarding Section 510(c):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination*, such as a *penalty*. . . .

Virtual Network Services, 902 F.2d at 1248; 11 U.S.C.A. § 510(c) note (1993) (Legislative Statements) (emphasis added); 124 Cong. Rec. H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini). What did Representative Edwards and Senator DeConcini mean by stating that a "penalty" is the type of claim susceptible to subordination? In the context of the distribution scheme of Section 726(a), perhaps they meant that penalties, other than tax penalties, are subject to the court's equitable subordination powers. Or they may have intended that only tax penalties that are punitive in nature, i.e. non-pecuniary loss penalties, be subject to equitable subordination. Despite the lack of clarity as to what Congress meant by claims that are "of a status susceptible to subordination," we must attempt to determine what claims are subject to equitable subordination. In any event, the legislative history indicates that penalty claims are susceptible to equitable subordination. Because Congress intended the "principles of equitable subordination" to follow existing case law, we turn

now to such case law as it existed in 1978 when the Bankruptcy Reform Act became effective. We will also examine further legislative history addressing what Congress may have meant when it specified a "penalty" claim as the type of claim susceptible to suborination.

At the time of the enactment of the Bankruptcy Code (Nov. 6, 1978), the case law on the principles of equitable subordination included three Supreme Court cases subordinating certain claims due to creditor misconduct and one appellate case subordinating the claims of defrauded shareholders, despite the absence of misconduct. *Comstock*, 335 U.S. 211; *Pepper*, 308 U.S. 295; *Taylor*, 306 U.S. 307; *In re Stirling Homex Corp.*, 579 F.2d 206, 211 (2d Cir. 1978) (affirming equitable subordination of the claims of allegedly defrauded stockholders to the claims of general unsecured creditors; stockholders were not guilty of misconduct), *cert. denied*, 439 U.S. 1074 (1979). The Commissioner argues that the principles of equitable subordination should not be expanded beyond cases of creditor misconduct, and certainly may not include the power to subordinate a postpetition tax penalty. To support this position, the Commissioner primarily relies on the absence of case law permitting the equitable suborination of tax penalty claims.

This absence of case law equitably subordinating tax penalty claims is explained by the fact that prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law. Under the Bankruptcy Act of 1898, and the ensuring reenactment of this provision in 1952, nonpecuniary loss tax penalty claims against the bankrupt's estate were simply not allowed as claims. "Debts owing to

the United States . . . as a penalty . . . shall not be allowed, except for the amount of the pecuniary loss sustained. . . ." Bankruptcy Act of 1898, ch. 541, § 57(j), 30 Stat. 561; 11 U.S.C. § 93(j), 66 Stat. 424 (1952). In 1961, the Supreme Court interpreted Section 93(j) broadly to disallow both secured and unsecured claims for tax penalties against the estate of the bankrupt. *Simonson v. Granquist*, 369 U.S. 38 (1962).

> [T]his section [57(j)/93(j)], which has been part of the Bankruptcy Act since its enactment in 1898, is in keeping with the broad aim of the Act to provide for the conservation of the estates of insolvents to the end that there may be as equitable a distribution of assets as is consistent with the type of claims involved. Moreover, *the prohibition of all tax penalties in bankruptcy* is wholly consistent with the policy of the penalty provisions themselves. Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.

Id. at 40-41 (emphasis added); *see also United States v. Coleman*, 344 F.2d 903, 909 (6th Cir. 1965) (noting that "[57(j)/93(j)] plainly manifests a congressional purpose to bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss").

Moreover, a few Circuits have recently developed the principles of equitable subordination to recognize the power of the bankruptcy court to subordinate a

prepetition, nonpecuniary loss tax penalty claim. The Third, Eighth, and Seventh Circuits have held that prepetition, nonpecuniary loss tax penalties are subject to equitable subordination in the appropriate case without a showing of government misconduct. *Burden* 917 F.2d at 115 (holding that prepetition, nonpecuniary loss tax penalties may be suborinated in a Chapter 13 case; bankruptcy court must balance equities; creditor misconduct not required); *Schulz Broadway Inn*, 912 F.2d at 230 (holding that equitable subordination provision applies to prepetition tax penalty claims of governmental units; misconduct not required; general unsecured creditors suffering actual losses should receive preference over Government's claim for prepetition, nonpecuniary loss penalty in liquidating Chapter 11 case); *Virtual Network Services*, 902 F.2d at 1246 (holding that bankruptcy court may equitably subordinate claim of IRS for prepetition, nonpecuniary loss tax penalties in liquidating Chapter 11 case; inequitable conduct not required). While these cases all concerned, prepetition penalties, the reasoning of these Circuits is equally applicable to postpetition penalties because the priority of both pre- and postpetition penalties is governed by 11 U.S.C. § 726(a), and this entire provision is subject to Section 510(c). Further, the legislative history of the sections we address indicates that Congress intended nonpecuniary loss tax penalties to be subject to the bankruptcy court's power to ensure that the distribution of the estate in a Chapter 7 case is equitable.

In Chapter 7 cases, Congress assigned differing priorities to pre- and postpetition penalties. 11 U.S.C. §§ 726(a)(1) and 726(a)(4). As discussed

above, Section 726(a)(1) gives administrative expense priority to *postpetition* tax penalty claims. However, unlike Section 726(a)(4), Section 726(a)(1) and its related statutes (Sections 507(a)(1) and 503(b)) do not distinguish between tax penalties that are compensatory in nature and those that are not. Section 726(a)(4), however, makes such a distinction and gives fourth priority to claims, "for any . . . penalty . . . arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such . . . penalty . . . [is] not compensation for actual pecuniary loss suffered by the holder of such claim." In other words, prepetition, as well as pre-appointment of trustee claims (whether pre- or postpetition), for nonpecuniary loss tax penalties are relegated to fourth priority. What priority Congress intended to give prepetition *pecuniary loss* tax penalty claims is unclear. Nevertheless, the language of Section 726(a)(4) indicates that in the collective mind of Congress a distinction exists between nonpecuniary loss ("punitive") penalties and pecuniary loss ("compensatory") penalties, at least so far as prepetition tax penalties are concerned.

This distinction surfaces elsewhere in the Bankruptcy Code. In Section 505, for example, the bankruptcy court is empowered to determine "the amount or legality of any tax . . . or penalty relating to tax." Prior to the approval of the final version of S. 2266, Senator DeConcini explained the House amendment to the Senate amendment to Section 505:

> The House Amendment authorizes the bankruptcy court to rule on the merits of any tax claim involving an unpaid tax, fine, or penalty relating to a tax, or any addition to a tax, of the

> debtor or the estate. This authority applies, in general, whether or not the tax, penalty, fine, or addition to tax had been previously assessed or paid. . . . The House amendment also adopts the substance of the Senate bill rule permitting the bankruptcy court to determine the amount of any penalty, *whether punitive or pecuniary in nature*, over which it has jurisdiction.

124 Cong. Rec. S17,426-27 (Oct. 6, 1978) (statement of Sen. DeConcini); 124 Cong. Rec. H11,110 (Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added). The distinction between punitive and pecuniary loss tax penalties also appears in Senator DeConcini's statements regarding Section 502 [Allowance of Claims] and regarding the priority scheme in Section 507. As to Section 502, Senator DeConcini stated:

> The Senate amendment allowed this reduction [tax claim resulting from reduction in FUTA tax credit], but would have subordinated it to other claims in the distribution of the estate's assets by treating it as a *punitive (nonpecuniary loss) penalty.*

124 Cong. Rec. S17,426 (Oct. 6, 1978). The distinction between pecuniary loss and nonpecuniary loss penalties is continued in Senator DeConcini's statement regarding Section 507 (to which Section 726 (a)(1) refers). This statement implies that pecuniary loss tax penalties have first priority:

> The House amendment also adopts the provisions of the Senate amendment which include in the definition of administrative expenses under section 503 any fine, penalty (including "additions to tax" under applicable tax laws) or reduction in credit imposed on the estate. . . . For purposes of the above [Section 507] priority rules, the House amendment adopts the provision of the Senate bill that any tax liability which, under otherwise applicable tax law, is collectible in the form of a "penalty," is to be treated in the same manner as a tax liability. In bankruptcy terminology, such tax liabilities are referred to as pecuniary loss penalties. Thus, any tax liability which under the Internal Revenue Code or State or local tax law is payable as a "penalty," . . . will be entitled to the priority which the liability would receive if it were expressly labeled as a "tax" under the applicable tax law. However, *a tax penalty which is punitive in nature is given subordinated treatment under section 726(a)(4).*

124 Cong. Rec. S17,428-30 (Oct. 6, 1978) (statement of Sen. DeConcini); 124 Cong. Rec. H11,113 (Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added).

The foregoing paragraph is evidence of Congress's desire to give first priority to something it calls "pecuniary loss penalties," if such things exist, and to give fourth priority to tax penalties that are truly penalties—i.e., that are punitive in nature. In light of this legislative history, including the distinction Congress has made between pecuniary loss and nonpecuniary loss tax penalties, we believe that Congress intended nonpecuniary loss, punitive penalties to be subject to the bankruptcy court's equitable subordination powers under Section 510(c). As mentioned above, both Section 726(a)(1) and 726(a)(4) are

subject to the courts' equitable subordination power under Section 510(c). This results is in accord with the Third, Seventh and Eighth Circuits' decisions interpreting the principles of equiable subordination to include the power to subordinate nonpecuniary loss tax penalties in bankruptcy cases under other chapters of the Bankruptcy Code.

In drafting Section 726(a)(1) and making it subject to Section 510(c), Congress made postpetition, nonpecuniary loss tax penalties, traditionally disallowed in bankruptcy, subject to the bankruptcy courts' equitable subordination power. A review of the sketchy legislative history of Section 510(c) reveals a statement by both of the leading legislators on this issue referring to penalties as a type of claim susceptible to subordination. The legislative history also reveals that Congress intended the courts to continue to develop the principles of equitable subordination. Therefore, we do not believe that Congress intended to arrest the development of the principles of equitable subordination as of 1978. Neither do we believe that the development of this area of law is restricted to cases of creditor misconduct. Compelling reasons of justice and equity, as well as our interpretation of the plain language of the statutes, and the legislative history regarding the purposely undefined phrase "principles of equitable subordination," move this Court to agree with the other Circuits that nonpecuniary loss tax penalty claims are one type of claim subject to equitable subordination.

The essence of bankruptcy is equity. While Congress has over the years re-codified traditional notions of equity, the current Code vests in the bankruptcy court significant discretion and equitable powers.

However, the bankruptcy court's equitable subordination powers must be exercised within the confines of the Bankruptcy Code. *In re Granger Garage, Inc.*, 921 F.2d 74, 77 (6th Cir. 1990). An examination of the Code reveals that the bankruptcy courts have the power to subordinate any claim to any other claim under the principles of equitable subordination; Congress has left the development of these principles to the courts. The wisdom of such a course is obvious, given the many ways in which parties to a bankruptcy seek advantage in recouping losses. We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

Our decision today does not mean that every tax penalty assessed by the Commissioner will be equitably subordinated. Section 726(a)(1) does not require automatic subordination, and, as we have observed, there may be cases where "penalties" are not actually punitive in nature but represent compensation for some actual loss. Section 505 leaves this determination to the bankruptcy court. As with every claim for equitable subordination under Section 510(c), the bankruptcy court must weigh the equities involved. We turn, then, to whether the bankruptcy court properly subordinated the tax penalty in this case.

The bankruptcy court determined that a postpetition tax penalty claim could be equitably subordinated if the equities so required. The court went on to find that the equities balanced in favor of general unsecured creditors who suffered actual losses, as opposed to the Commissioner whose actual losses, the tax and interest claims, retained their first priority status. Because the parties agreed that the tax penalty claim was for nonpecuniary loss, the bankruptcy court did not have to decide that issue in balancing the equities of the case. Therefore, because the bankruptcy court did not clearly err in making its findings of fact, or err in its application of the law, we believe that the district court properly affirmed the decision of the bankruptcy court equitably subordinating the Commissioner's postpetition tax penalty claim to the claims of general unsecured creditors. We therefore AFFIRM the judgment of the district court.

ALICE M. BATCHELDER, Circuit Judge, concurring. I write separately only to express my view that 11 U.S.C. § 726(a) is clear and unambiguous and therefore we have no reason to speculate about the intent of particular legislators or of the Congress as to what was intended by that section. As the majority opinion points out, the Supreme Court has made it clear that we are to look to the language of the statute to determine the statute's meaning. When the statute speaks with clarity to the issue we address, our inquiry is, "in all but the most extraordinary circumstances," over. *Estate of Floyd Coward v. Nicklos Drilling Co.*, 112 S. Ct. 2589, 2594 (1991) (citation omitted), *cert. denied sub nom. Barger v. Petroleum Helicopters, Inc.*, 112 S. Ct. 3026 (1992). There are no such extraordinary circumstances present here.

Section 726(a) says that except as provided in 11 U.S.C. § 510, property of the estate is to be distributed first to pay claims of the kind and in the order specified in 11 U.S.C. § 507. Section 510 permits equitable subordination of claims. Section 507 governs priorities and gives first priority to administrative expenses allowed under § 503. Title 11 U.S.C. § 503 governs allowance of administrative expenses and allows as an administrative expense any tax incurred by the estate and any penalty relating to a tax incurred by the estate. By definition, penalties on taxes incurred by the estate are postpetition penalties. Section 503 does not set any priorities among administrative expenses; it simply identifies what those expenses are. Read together, §§ 726, 507, and 503 require that when property is distributed in a Chapter 7 proceeding, it goes first to pay administrative expenses, which include taxes incurred by the estate and penalties relating to those taxes, and that this entire

distribution scheme is subject to the equitable subordination power of the court as set out in § 510.

I have no quarrel with the majority's exploration of the legislative history behind § 510(c) in order to determine what the Congress intended by the term "principles of equitable subordination," which is nowhere defined in the statute. Noting the absence of case law equitably subordinating tax penalty claims at the time the Bankruptcy Code was adopted, the majority rightly concludes that this absence of case law is explained by the fact that before the Code was enacted, nonpecuniary loss tax penalty claims against the estate were simply not allowed at all. Further, the majority looks to subsequent case law, noting that that body of law permits equitable subordination to prepetition nonpecuniary loss tax penalty claims. So far, so good.

Having determined the meaning of "principles of equitable subordination," however, nothing requires us to delve into the legislative history of § 726. Specifically, nothing in § 726 itself permits, much less requires, a review of the legislative history of that section as part of our analysis of whether postpetition nonpecuniary loss tax penalties are subject to equitable subordination. Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

Because the unambiguous language of § 726 permits the equitable subordination of postpetition tax penalties, it is not necessary for us to undertake any further analysis. Indeed, it is necessary that we not do so.

APPENDIX B

[Filed Mar. 2, 1995]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No.: 93-4311

IN RE: FIRST TRUCK LINES, INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

THOMAS R. NOLAND, Trustee, APPELLEE

Before: MARTIN, and BATCHELDER, Circuit Judges; and ENSLEN, District Judge

JUDGMENT

ON APPEAL from the United States District Court for the Southern District of Ohio at Dayton.

THIS CAUSE was heard on the record from the district court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is ORDERED that the judgment of the district court is AFFIRMED.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green
LEONARD GREEN
Clerk

Issued as Mandated: March 24, 1995

APPENDIX C

[Filed Jun. 16, 1995]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 93-4311

IN RE: FIRST TRUCK LINES, DEBTOR

UNITED STATES OF AMERICA, IRS,
PLAINTIFF-APPELLANT

v.

THOMAS R. NOLAND, TRUSTEE, DEFENDANT-APPELLEE

ORDER

Before: MARTIN, and BATCHELDER, Circuit Judges; and ENSLEN,* District Judge.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

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* Hon. Richard A. Enslen, Chief Judge United States District Court for the Western District of Michigan, sitting by designation.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green
LEONARD GREEN
Clerk

APPENDIX D

[Filed Sep. 21, 1993]

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. C-3-92-304

JUDGE WALTER HERBERT RICE

INTERNAL REVENUE SERVICE, APPELLANT

vs.

THOMAS R. NOLAND, TRUSTEE, APPELLEE

DECISION AND ENTRY AFFIRMING THE DECISION OF THE BANKRUPTCY COURT; JUDGMENT TO BE ENTERED IN FAVOR OF APPELLEE AND AGAINST APPELLANT; TERMINATION ENTRY

This is an appeal by the Internal Revenue Service ("IRS") from a decision by the United States Bankruptcy Court, subordinating the IRS's claim of tax penalties to the priority of the claims of general, unsecured creditors. This appeal arises out of a bankruptcy petition under Chapter 11 of the Bankruptcy Code, which First Truck Lines ("FTL") filed on April 10, 1986. After filing the petition, FTL continued its business operations as a debtor in possession. However, during its postpetition operations, FTL did not pay to the IRS the FICA and FUTA

taxes which accrued. FTL discontinued business operations, and, on August 1, 1988, the Bankruptcy Court converted the Chapter 11 proceedings to a Chapter 7 liquidation.

After this case was converted to a Chapter 7 proceeding, the Bankruptcy Court was called upon to distribute, among the various parties filing claims, the property of FTL's estate. The IRS had filed a claim for the unpaid FICA and FUTA taxes, interest on those taxes, as well as penalties on those taxes ("tax penalties").[1] The IRS further sought to have the Bankruptcy Court hold that all three components of its claim were entitled to priority as administrative expenses. The Bankruptcy Court agreed with the IRS that the three components of the IRS's claim were administrative expenses; however, pursuant to § 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c), that court held that IRS's claim for tax penalties should be equitably subordinated to the status of the claims of general unsecured creditors.[2] Thus, the IRS's claim was given priority for the unpaid taxes and for the interest on those taxes; however, its claim for tax penalties was not given such priority. The Bankruptcy Court subordinated the IRS's claim for tax *penalties* because, unlike business creditors, the IRS had not suffered an actual pecuniary loss with

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[1] The IRS filed a claim and an amended claim for taxes, interest and tax penalties, seeking the sum of $128,756.64. The trustee argued before the Bankruptcy Court that the amended claim was not a proper claim; however, that court concluded that it was a proper claim. Accordingly, that question is not before this Court, and the Court will treat the two claims (original and amended) as one.

[2] The Bankruptcy Court's decision is reported. *In re First Truck Lines, Inc.*, 141 B.R. 621 (Bkrtcy.S.D.Ohio 1992).

regard to the penalties. In other words, the IRS's claim for tax penalties, unlike those of all business creditors, did not arise atfer the surrendering of a valuable asset to the debtor.

Before this Court, the IRS presents two arguments, to wit: 1) that administrative expenses can never be equitably subordinated; and 2) that, if such expenses can be subordinated, the Bankruptcy Court improperly subordinated the tax penalties in this case. As an initial matter, the Court will set forth the familiar standard against which it must review the Bankruptcy Court's decision in this litigation. This Court reviews the Bankruptcy Court's findings of fact under a clearly erroneous standard and conducts a *de novo* review of that court's conclusions of law. *In re Caldwell*, 851 F.2d 852, 857 (6th Cir. 1988). *See also*, Bankruptcy Rule 8013.

First, the IRS argues that the tax penalties are administrative expenses and that such expenses are never subject to equitable subordination, because they are given such a high priority in § 507 of the Bankruptcy Code, 11 U.S.C. § 507. Although the tax penalties were administrative expenses,[3] this Court does not agree with the IRS that such expenses are never subject to equitable subordination. This argument presents a simple question of statutory construction. This question, like every question of statutory construction, compels this Court to determine the intent of Congress. The starting point of that analysis is,

[3] Section 507(a)(1) provides that expenses allowed under § 503(b) are administrative expenses. Section 503(b) provides that certain taxes and related penalties, including those herein, are administrative expenses. The Appellee concedes that the tax penalties are administrative penalties. *See* Doc. #6 at 2.

of course, the language of the statute. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). When construing the Bankruptcy Code (and other statutes), the Supreme Court has cautioned that that inquiry must end "when the statute's language is plain." *Id.* The provision which this Court must construe is § 726(a) of the Bankruptcy Code, 11 U.S.C. § 726(a), which governs the distribution of the property in a Chapter 7 debtor's estate. Section 726(a) provides, in pertinent part:

> Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title.

Section 507 is the provision by which administrative expenses are given priority. Section 510(c) of the Bankruptcy Code plainly confers upon the court the power to equitably subordinate claims.[4] Given the plain and clear language of § 726(a), it is simply not possible to conclude that administrative expenses are not subject to equitable subordination. Moreover, other courts have concluded that administrative expenses are subject to equitable subordination. For instance, in *In re Import & Mini Car Parts, Ltd., Inc.*,

[4] Section 510(c) provides, in pertinent part:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest.

136 B.R. 178, 181 (Bkrtcy.N.D.Ind. 1991), the court rejected the proposition that administrative expenses cannot be equitably subordinated, stating:

> [T]he IRS first argues that section 510(c) does not authorize the subordination of administrative expenses. Based upon the plain language of section 726(a) this argument cannot prevail. The distributive scheme established by § 726 is expressly subject to the power of subordination pursuant to § 510.

Accord In re F.A. Potts & Co., 114 B.R. 92 (Bkrtcy. E.D.Pa. 1990). Accordingly, this Court must decline the IRS's invitation to rewrite the plain language of § 726(a) and concludes that administrative expenses (in this case tax penalties) are subject to equitable subordination.

Second, having determined that administrative expenses can be equitably subordinated, the question remains as to whether the Bankruptcy Court correctly concluded that the administrative expenses (the tax penalties) in this litigation should be so subordinated. Section 510(c) does not expressly state when a claim may be equitably subordinated; rather, that section provides that claims may be subordinated "under principles of equitable subordination." The legislative history to § 510(c) explains:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts the development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or if the claim itself is of a status susceptible to subordination, *such as a penalty* . . .

124 Cong.Rec. H11089 (Sept. 28, 1978) (statement of Rep. Edwards), *reprinted in*, 1978 USCC&AN 5787, 6452 (emphasis added); 124 Cong.Rec. S17406 (Oct. 6, 1978) (statement by Sen DeConcini), *reprinted in* 1978 USCC&AN 6505, 6521 (emphasis added).[5] Herein, there is no hint or allegation that the IRS was guilty of inequitable conduct; therefore, the only question for this Court is whether a claim for a tax penalty is of the status susceptible to subordination.

Although the Sixth Circuit has not addressed the question,[6] other circuits have consistently held that claims for tax penalties are subject to equitable subordination, even in the absence of misconduct by the government. *See, e.g., Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *Burden v. United States*, 917 F.2d 115 (3rd Cir. 1990); *Matter*

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[5] The Supreme Court has treated the statements, by Representative Edwards and Senator DeConcini, on the Bankruptcy Reform Act of 1978, as "persuasive evidence of congressional intent." *Beiger v. IRS*, 496 U.S. 53, 64 n. 5. *See also, In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1058 n. 3 (6th Cir. 1991).

[6] In *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1062 (6th Cir. 1991), the Sixth Circuit quoted the statement and held that the excise tax was not subject to equitable subrogation because the IRS was not guilty of inequitable conduct and the tax was not a penalty. However, the *Mansfield Tire* court did not suggest that a tax penalty is not subject to equitable subordination. Indeed, the *Mansfield Tire* court recognized that equitable subordination is appropriate "if the claim itself is of a status susceptible to subordination." *Id.*

of Virtual Network Services Corp., 902 F.2d 1246 (7th Cir. 1990). These courts have held that a court must balance the equities before subordinating a tax penalty. For instance, in *Virtual Network*, the Seventh Circuit held that the district court correctly concluded that the equities tipped in favor of subordination because it was unfair to allow the tax penalties to come from the pockets of other creditors. *Id.* at 1250. In *Schultz*, the Eighth Circuit upheld the district court's decision to equitably subordinate tax penalties and commented that the decision "accords with the legislative history of the Bankruptcy Reform Act, which generally prefers claims for actual losses over punitive claims." 912 F.2d at 234.

After weighing the equities, the Bankruptcy Court concluded that principles of equitable subordination upheld the subordination of the tax penalties in this case. This Court concludes that the Bankruptcy Court reached the proper balance. The IRS's claim for tax penalties is unquestionably a penalty,[7] an additional

[7] Before the adoption of the Bankruptcy Reform Act of 1978, tax penalties were specifically disallowed as claims against a bankrupt's estate. *Burden*, 917 F.2d at 117. In *Simmonson v. Granquist*, 369 U.S. 38, 41 (1962), the Supreme Court explained the rationale behind that disallowance:

> Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.

See also, In re Cassidy, 983 F.2d 161, 164 (10th Cir. 1992) ("The policy of protecting unsecured creditors from the bad conduct of the debtor is best implemented by avoiding burdening the claims of unsecured creditors with penalties imposed on the debtor.").

assessment, so to speak, for the debtor's having failed to pay the taxes and the interest due on the taxes in a timely manner, sums which, unlike the statutory penalties, represent actual losses (or the loss of the use of money) to the IRS. The IRS has priority to its claims for unpaid taxes and for interest on those taxes; therefore, it will not suffer a pecuniary loss if it does not obtain priority for the tax penalties. The same cannot be said for other creditors; rather, those persons provided value to FTL and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it. Accordingly, this Court concludes that the equities tip in favor of subordinating the IRS's claim for tax penalties in this case.

Based upon the foregoing, this Court affirms the Bankruptcy Court's decision to subordinate the IRS's tax penalties to the priority of the claims of general unsecured creditors. Judgment is to be entered in favor of the Appellee and against the Appellant.

The captioned cause is hereby terminated upon the docket records of the United States District Court for the Southern District of Ohio, Western Division, at Dayton.

/s/ Walter Herbert Rice
WALTER HERBERT RICE
United States District
Judge

APPENDIX E

[Entered Jan. 25, 1992]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. 3-86-00925
Chapter 7 (Judge Waldron)

IN RE: FIRST TRUCK LINES, INC., DEBTOR

DECISION ON ORDER ON OBJECTION

DATED AT DAYTON, OHIO this 25th day of June, 1992:

This proceeding, which arises under 28 U.S.C. § 1334(b) in a case referred to this court by the Standing Order of Reference entered in this district on July 30, 1984, is determined to be a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B)—allowance or disallowance of claims against the estate and estimation of claims.

Presently before the court is an objection filed by the trustee to the tax claims filed by the Internal Revenue Service (Doc. 193). A hearing on this objection was held and this proceeding was taken under advisement.

BACKGROUND

The parties filed a Stipulation Of The Trustee And the United States Of America Relating To Allowance

Or Disallowance Of Claims Of the Internal Revenue Service (Doc. 216). The relevant stipulations are as follows:

1) The parties agree that this court has jurisdiction to determine the claims and requests of the Internal Revenue Service (the "IRS").

2) On April 10, 1986, the debtor voluntarily filed for relief under chapter 11 of the Bankruptcy Code.

3) The debtor moved to convert the case to chapter 7 in June, 1988. An order converting this case to chapter 7 was entered on August 1, 1988.

4) The bar date for filing claims in the chapter 7 proceeding was December 1, 1988.

5) On November 22, 1988, the IRS filed a Request for Payment of Administrative Expenses which was numbered 102 by the clerk ("Claim 102"). The amounts listed in Claim 102 involve claims which accrued postpetition and preconversion for taxes, interest, and penalties. Claim 102 did not include any claims made in previous claims or requests filed by the IRS in this case.

6) On April 20, 1989, the IRS filed a Request for Payment of Administrative Expenses which was numbered 107 by the clerk ("Claim 107").

7) On August 7, 1991, the trustee filed an objection to Claim 102 and Claim 107.

8) In response to this objection, the United States filed the United States Opposition To Trustee's Objection To Allowance Of Claims Of Internal Revenue Service (Doc. 196) and a Memorandum Of Law In Support Of The United States' Opposition To Trustee's Objection To Allowance Of Claims of Internal Revenue Service (Doc. 210). The Trustee filed a Response Of Trustee To Memorandum Of USA In

Opposition To Objection To Claim (Doc. 198) and a Memorandum Of Trustee Relative To Memorandum Of Law In Support Filed by USA For Allowance Of Claims Of The Internal Revenue Service (Doc. 211).

9) The parties agree that the tax and interest amounts in Claim 102 will be allowed as an administrative expense claim with priority under Sections 503(b), 507(a)(1), and 726(a)(1). However, the parties request that the court determine the priority, if any, of the penalties related to Claim 102.

10) The parties agree that the tax and interest claims made in Claim 107 involving quarters ending December 31, 1986 (WT-FICA) for $964.80 and December 31, 1987 (WT-FICA) for $74,670.39 are claims not raised in previous claims and should be subordinated pursuant to Section 726(a)(3). However, the parties request that the court determine the priority, if any, of the penalties related to Claim 107.

11) The parties agree that, with respect to Claim 107, the quarters ending September 30, 1986 (WT-FICA) for $264.51, September 30, 1987 (WT-FICA) for $28,039.08, March 31, 1988 (WT-FICA) for $24,363.81, June 30, 1988 (WT-FICA) for $29,718.50, the FUTA tax for the year 1987 for $3,709.46, and the corporate income tax for the year 1987 for $300.00 are the same amounts sought in previous claims timely filed in these proceedings.

12) The parties agree that, with respect to Claim 107, the amount claimed for FUTA tax for the year 1988 was greater in amount than the amount claimed in Claim 102 for the same year and that Claim 102 delineated the 1988 year as being estimated. The United States maintains that the increased amount for FUTA tax should be allowed as an administrative

expense, but the trustee maintains that the increased amount for FUTA tax should not be allowed. The parties agree that, if Claim 107 is allowed as an amended claim, the court should determine the priority, if any, of the penalties included in Claim 107.

ISSUES

Based upon the parties' stipulations, this court finds that the following issues are before this court for determination:

1) With respect to Claim 102, what priority will the tax penalties be accorded.

2) With respect to Claim 107, will a) the FUTA tax be allowed as an amendment to Claim 102 and allowed as an administrative expense, b) the penalty related to this FUTA tax be allowed as an amendment to Claim 102, and if so, what priority will it be accorded, and c) the penalties related to FICA claims, which have not been previously asserted, be allowed, and if so, what priority will these penalties be accorded.

DISCUSSION

The resolution of the interrelated issues of federal tax priorities, penalties, and subordination requires an examination of the interstices of several seemingly contradictory provisions of the Code (11 U.S.C. § 348, § 503, § 507, § 510, and § 726). The subject of an "appropriate analytical task" and an "agreed upon methodology" in statutory interpretation of the Bankruptcy Code has been continually emphasized in recent Supreme Court decisions. *Patterson v. Shumate*, No. 91-913, 1992 U.S. LEXIS 3546, 60 U.S.L.W. 4550 (U.S. June 15, 1992). This methodology may

be described by acknowledging that, although "canons of construction are no more than rules of thumb that help courts determine the meaning of legislation," *Connecticut Nat'l Bank v. Germain*, —— U.S. ——, 112 S.Ct. 1146, 1149 (1992), the initial examination commences with the language of the statute. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 110 S.Ct. 2126, 2130 (1990) ("the fundamental canon [of] statutory interpretation begins with the language of the statute itself."). "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Germain*, 112 S.Ct. at 1149. If the statutory language is ambiguous a court must resort to examination of legislative history. *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S.Ct. 1026, 1030 (1989). As the Supreme Court stated in *Ron Pair*, "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" 109 S.Ct. at 1031. "In such cases, the intention of the drafters, rather than the strict language, controls." 109 S.Ct. at 1031. Further, it is necessary to note that a court should be reluctant to "accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, —— U.S. ——, 112 S.Ct. 773, 779 (1992).

I. Claim 10

The parties request that this court determine the priority to be accorded the postpetition, preconversion non-pecuniary loss tax penalties asserted in this claim. The IRS asserts that postpetition, preconversion tax penalties are administrative expenses entitled to the priority accorded by 11 U.S.C. § 507(a)(1). Section 507(a)(1) provides:

> (a) The following expenses and claims have priority in the following order:
>
> (1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

The administrative expenses allowed under § 503(b) include the taxes incurred by a bankruptcy estate. Section 503(b)(1) provides:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f), of this title, including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case:
>
> (B) any tax—
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(7) of this title; or
>
> (ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates

> ended before or after the commencement of the case; and
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph[.]

The parties have agreed that the tax and interest sought in Claim 102 will be allowed as an administrative expense under § 503(b). Because of the Code's express reference to taxes in § 503(b)(1)(B), this court determines that the parties have stipulated that the taxes will be allowed under this subsection.

As § 503(b)(1)(C) demonstrates, the penalties related to taxes which come within the provisions of § 503(b)(1)(B) are administrative expenses. Therefore, having been expressly defined as administrative expenses, the postpetition tax penalties receive first priority under § 507(a)(1).

The trustee contends, however, that these tax penalties should be subordinated. Initially, the trustee asserts that, as a result of the conversion of this case from a case under chapter 11 to a case under chapter 7, the provisions pertaining to distribution in liquidation cases, specifically § 726(a)(4), dictate the priority of the tax penalties. Section 726(a)(4) provides:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief

> or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim[.]

At first blush it appears that there is a conflict between § 503(b)(1)(C) and § 726(a)(4), since both sections contain the same term "penalty" but do not accord it the same priority. Resolution of this conflict is found in the provisions in 11 U.S.C. § 348(d). Section 348(d), pertaining to conversion, provides:

> (d) A claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1307, or 1208 of this title, *other than a claim specified in section 503(b) of this title*, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition.

(Emphasis supplied).

Section 348(d), by expressly omitting claims under § 503(b), prevents chapter 11 administrative claims from becoming prepetition claims upon conversion. *United States v. Ginley (In re Johnson)*, 901 F.2d 513, 520 (6th Cir. 1990); *In re Bondi's Valu-King, Inc.*, 102 B.R. 108, 111 (Bankr. N.D. Ohio 1989), *aff'd*, 126 B.R. 47 (N.D. Ohio 1991); 2 *Collier On Bankruptcy* para. 348.05 at 348-10 (15th ed. 1991). Accordingly, the express statutory language indicates that these penalties retain their status as administrative claims under § 503(b)(1)(C) and are to be paid in accordance with the distribution provisions set

forth in § 726(a)(1)[1] and § 726(b),[2] and not the provisions contained in § 726(a)(4).

The trustee alternatively argues that the postpetition tax penalties sought by the IRS in Claim 102 should be equitably subordinated under 11 U.S.C. § 510(c)(1). Section 510(c)(1) provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest[.]

The Bankruptcy Code does not expressly define the phrase "equitable subordination," therefore, it is

[1] (a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) First, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title[.]

[2] Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6) or (7) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, exceut that in a case that has been converted to this chapter under section 1112, 1208 or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

necessary to resort to an examination of the legislative history of the Code.[3] Legislative history indicates that the meaning of the phrase "equitable subordination" was to be developed by the courts. The Congressional Record states:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11089, H11095 (1978) (emphasis added) (remarks of Rep. Edwards), *printed in* 1978 U.S. Code Cong. & Admin. News 6436, 6452; *see also* 124 Cong. Rec. S17406, S17412 (1978) (remarks of Sen. DeConcini), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6505, 6521. *See also United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 942 F.2d 1055, 1062 (6th Cir. 1991) ("We continue to recognize that equitable subordination in bankruptcy may be appropriate if the claimholder is guilty of inequitable conduct or if the claim itself is of a status susceptible to subordination.").

Section 510(c)(1) has been utilized to subordinate claims for non-pecuniary tax penalties. *Burden v.*

[3] As the Third Circuit noted in *Burden*, "[p]rior to the enactment of the Bankruptcy Act of 1978, subordination of tax penalty claims did not occur because noncompensatory penalty claims owed to the government were specifically disallowed. 917 F.2d at 117 (citations omitted).

United States, 917 F.2d 115 (3d Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990); *In re Manchester Lakes Assocs.*, 117 B.R. 221, 225 (Bankr. E.D. Va. 1990); *In re Merwede*, 84 B.R. 11, 14 (Bankr. D. Conn. 1988). These claims have been subordinated despite the absence of creditor misconduct. *Burden*, 917 F.2d at 120; *Schultz Broadway Inn*, 912 F.2d at 233; *Virtual Network Services*, 902 F.2d at 1250; *In re Merwede*, 84 B.R. at 14. The determination of whether a penalty should be subordinated requires the court to weigh the equities of the various claims on a case-by-case basis. *Burden*, 917 F.2d at 120; *Schultz Broadway Inn*, 912 F.2d at 234; *Virtual Network Services*, 902 F.2d at 1250. Otherwise, subordination would automatically occur merely because a claim is a penalty, and a major revision in the bankruptcy law such as this would warrant explicit direction from Congress. *Burden*, 917 F.2d at 119.

The IRS acknowledges that courts have subordinated tax penalties under § 510(c)(1) but contends that these decisions are not applicable to this proceeding because ethey involve prepetition tax penalties, and not postpetition tax penalties. In support of its contention the IRS distinguishes the penalties sought in this proceeding from those in *Virtual Network Services*.

In *Virtual Network Services*, the Seventh Circuit addressed the issue of whether prepetition non-pecuniary loss tax penalties could be equitably subordinated under § 510(c)(1). 902 F.2d at 1247-50. In examining the equities of the case before it, the appeals court concluded that non-pecuniary loss tax penalties could be subordinated under 11 U.S.C.

§ 510(c)(1). In reaching this determination, the appeals court examined the IRS's challenges to the district court's holding that equitable subordination would be applied to the case "because 1) the goal of equitable subordination focuses not on the conduct of the creditor but on a fairness to creditors in a particular case, 2) punishing or deterring VNS's [the debtor's] innocent creditors because of VNS's wrongful conduct serves no purpose, and 3) the IRS's claims in this case are punitive in nature." *Virtual Network Services*, 902 F.2d at 1250. Specifically, the IRS challenged the district court's holdings on grounds 2 and 3.

With respect to the district court's holding in ground 2, the IRS asserted, on appeal, that it was just as innocent as the debtor's general unsecured creditors, thus it was unfair to punish it in relation to those other creditors. In addressing this contention, the appeals court noted that the IRS had been found innocent by the district court, but that the district court also emphasized "that it [the IRS] had waited too long to collect its debt, therefore, making it unfair for the court to shift the burden of the debt to other innocent creditors." *Virtual Network Services*, 902 F.2d at 1250. With respect to its objection to ground number 3, the appeals court stated that the IRS was challenging the district court's findings that the tax penalty claims were punitive by attempting to recharacterize the nature of its claims as being unlike other non-pecuniary loss penalties because they are designed to not only punish the debtor, but to protect " 'the integrity of tax systems and to reimburse the Government for . . . costs incurred as a result of certain taxpayer misconduct.' " *Virtual Network Services*, 902 F.2d at 1250. In addressing this con-

tention, the appeals court noted that this argument had not been properly raised to the district court by the IRS; but, nonetheless, stated, "this vague assertion is an attempt to diffuse the purpose behind the tax penalties, *i.e.*, to punish those who fail to abide by the taxing structure, and to deter those who might be inclined to avoid tax payment." *Id.* The court concluded, "allowing the IRS to recover its non-pecuniary loss claims along with others who have actually 'invested' in VNS [the debtor] and lost would be unfair on these facts." *Id.* The appeals court further stated:

> As for the other grounds that the district court relied on in applying equitable subordination to the IRS's claims, we are persuaded that the district court accurately addressed the equities of this case. The district court correctly considered that it was unfair to allow the IRS's tax penalty claims to come out of the "pockets" of other general unsecured creditors who had not been paid their pecuniary losses. Moreover, in this case the debtor has sold most of its operating assets and filed an amended plan for liquidation. In other words, VNS [the debtor] exists in name only, as an entity out of which remaining funds are distributed, in this case between 15-30% of that due, to its creditors. We agree that the equities in this case favor the subordination of the IRS's claims to those of the other general unsecured creditors.

902 F.2d at 1250.

Similarly, the Eighth Circuit, in *Schultz Broadway Inn*, concluded that the IRS's tax penalty claims would be subordinated under § 510(c)(1). 912 F.2d

at 234. Notably, in *Schultz Broadway Inn*, the Government argued that subordination of non-pecuniary loss penalties is precluded under chapter 11 because Congress, as evidenced by its express subordination of non-pecuniary loss penalty claim in § 726(a)(4), intended to restrict subordination of punitive claims to proceedings under chapter 7. 912 F.2d at 233. The *Schultz Broadway Inn* court rejected the Government's argument and stated:

> [I]n proceedings under chapter 7, Congress could be certain that in most cases the debtor would cease operations with assets that were insufficient to cover the creditors' claims in full. Therefore, in the chapter 7 context, a uniform rule subordinating penalty claims recognizes that ordinary creditors should receive protection from debtors' punitive obligations.
>
> The same rule, however, would be inappropriate for proceedings under chapter 11. In chapter 11 proceedings, Congress expected that many debtors would continue their operations under a reorganization plan and ultimately return to a viable and profitable economic state. In such cases, the debtor, quite rightly, should bear the burden of its full punitive obligations. Where a chapter 11 debtor opted to liquidate, however, the consequences to creditors could be very similar to a proceeding under chapter 7.

912 F.2d at 233 (citation omitted). The *Schultz Broadway Inn* court concluded that, in accordance with the "legislative history of the Bankruptcy Reform Act, which generally prefers claims for actual losses over purely punitive claims," the "general unsecured creditors who suffered actual losses should

receive preference over the Government's claim for a non-pecuniary loss tax penalty in this liquidating chapter 11." 912 F.2d at 234. However, the court noted that, despite the preference for compensating creditors' actual losses first, appropriate circumstances may exist such that the Government's non-pecuniary loss claims will not be subordinated, but the "Government bears the burden of directly bringing such equitable considerations to the bankruptcy court's attention." *Id.*

As previously stated, in determining whether to subordinate a claim under § 510(c)(1), the various equities of the claims must be considered, The nature of the claim as arising prepetition or postpetition is only one of several factors to weigh when balancing the equities in a proceeding. In attempting to balance the equities in its favor, the IRS has made several assertions. First, the IRS asserts that it has not waited too long to collect the debt owed it when the debtor has been in bankruptcy. This court agrees. In this proceeding, unlike in *Virtual Network Services*, the IRS has not waited too long to collect its debt. Second, the IRS asserts that requiring debtors to pay penalties which are administrative expenses does not punish innocent creditors, but rather insures that chapter 11 debtors obey the law while they are under the protection of the bankruptcy court. This assertion, similar to that made by the IRS in *Virtual Network Services*, is unpersuasive in this liquidation proceeding. Penalties may punish a debtor who is attempting to reorganize and may insure that the debtor obeys the tax laws; however, in a Chapter 7 liquidation or in a liquidating chapter 11, the parties who are punished are other creditors because payment

of penalties reduces estate assets available for distribution. Third, the IRS asserts that, although the Bankruptcy Code provides for the readjustment of prepetition debts, the Code requires that administrative expenses are not to be readjusted but are to be paid in full. The IRS's assertion is correct but not complete since it ignores the equitable principles contained in § 510(c)(1). Under principles of equity, particularly when such principles are expressly contained in statutory enactments, the rigidity of otherwise applicable law is modified to comply more appropriately with legislative intention. Lastly, the IRS asserts that it would be inequitable to allow the debtor to subordinate a liability incurred by the debtor while under the protection of the bankruptcy court. Although "[t]he inclusion of penalties on postpetition taxes in section 503(b) indicates that Congress was willing to have the bankruptcy estate pay for expenses that arise out of the failure of the debtor in possession or the trustee to pay taxes in a timely manner," *United States v. Flo-Lizer, Inc.* (*In re Flo-Lizer, Inc.*), 916 F.2d 363, 366 (6th Cir. 1990), again, the provisions of § 510(c)(1) incorporate the principle of equitable subordination and, accordingly, the court must consider the equities of all claims, not just the priority of the claims of the IRS.

Weighing the foregoing against the Code's preference for compensating actual loss claims, and the fact that, in this liquidation proceeding, it appears the total amount of assets to be distributed will fully compensate only the first priority claim holders and will be distributed on a *pro rata* basis to the second priority claim holders, the court concludes that the equities tilt in favor of subordinating the postpetition

non-pecuniary loss tax penalties sought by the IRS. *See Walker v. Ferguson* (*In re Import & Mini Car Parts, Ltd., Inc.*), 136 B.R. 178, 182 (Bankr. N.D. Ind. 1991) (court analyzed the decision in *Virtual Network*, *Burden*, and *Schultz Broadway Inn* and concluded that, as a result of the equities existing in the proceedings, the postpetition tax penalties would be subordinated);[4] *In re F.A. Potts & Co., Inc.*, 114 B.R. 92, 94 (Bankr. E.D. Pa. 1990) (postpetition tax penalties assessed against debtor were subordinated under § 510(c)(1)).

II. Claim 107

This court must determine whether Claim 107, filed after the bar date, may be allowed as an amendment. Specifically, this court must determine whether the FUTA tax listed in Claim 107 may be allowed as an amendment to the FUTA tax listed in Claim 102 and as an administrative expense. Additionally, this court must determine the priority of the penalty related to the additional FUTA tax and the priority, if any, of the penalties related to the FICA claims not previously listed in any timely filed claim.

The determination of whether to permit an amendment to a timely filed proof of claim rests within the discretion of the court. *In re Wilson*, 136 B.R. 719, 721 (Bankr. S.D. Ohio 1991); *In re Parsons*, 135 B.R. 283, 284 (Bankr. S.D. Ohio 1991); *In re McLean Indus., Inc.*, 121 B.R. 704, 708 (Bankr. S.D.N.Y.

[4] However, unlike the courts in *Virtual Network Services* and *Schultz Broadway Inn*, the bankruptcy court, as the trustee requested, subordinated the tax penalties to the other unpiad chapter 11 administrative expenses. *Id.*

1990); *In re Milan Steel Fabricators, Inc.*, 113 B.R. 364, 368 (Bankr. N.D. Ohio 1990). In making this determination courts have developed a two-part test. *Parsons*, 135 B.R. at 284; *McLean*, 121 B.R. at 708; *Bishop v. United States* (*In re Leonard*), 112 B.R. 67, 71 (Bankr. D. Conn. 1990).

Under the first prong of the test, the court must determine whether the amendment reasonably relates to a timely filed claim or whether it is merely an attempt to file a new claim. *United States v. Simon* (*In re Bondi's Valu-King, Inc.*), 126 B.R. 47, 49 (N.D. Ohio 1991); *Wilson*, 136 B.R. at 721; *McLean*, 121 B.R. at 708; *Milan Steel Fabricators*, 113 B.R. at 367. ("[A]mendment to a claim is freely allowed where the purpose is to cure a defect in the claim as orignally filed, to describe the claim with greater particularity or to plead a new theory of recovery on the facts set forth in the original claim." *Milan Steel Fabricators*, 113 B.R. at 368 (quoting *United States v. Int'l Horizons, Inc.* (*In re Int'l Horizons, Inc.*), 751 F.2d 1213, 1216 (11th Cir. 1985)). Examples of amendments permitted include a correction in "the amount of tax, penalties or interest claimed in a timely filed claim." *In re Unroe*, 937 F.2d 346, 349 (7th Cir. 1991). However, if the claim is a new claim, it will be disallowed. *Milan Steel Fabricators*, 113 B.R. at 367.

Under the second prong, the court must perform an equitable analysis. *McLean*, 121 B.R. at 708; *In re Leonard*, 112 B.R. at 71. In *McLean*, the court set forth indicia to consider when balancing the equities, including:

1) whether there is undue prejudice to an opposing party,

2) whether there is bad faith or dilatory behavior on the part of the claimant,

3) whether other creditors would receive a windfall were the amendment not allowed,

4) whether other claimants might be harmed or prejudiced,

5) whether there is justification for the inability to file the amended claim at the time the original claim was filed.

121 B.R. at 708. *See also Parsons*, 135 B.R. at 285.

It is undisputed that Claim 102, the original claim, was timely filed. Claim 102 sets forth the FUTA tax owed by the debtor for two tax periods, December 31, 1987 and December 31, 1988, and states at the bottom of the claim: "Estimated tax claims have been filed because the debtor has failed to file the return(s) for the estimated periods. As soon as the debtor files the return(s) with the I.R.S. as required by law, this claim will be adjusted as necessary." The parties have agreed that the FUTA tax claims in Claim 102 will be allowed as administrative claims.

It is undisputed that the FUTA tax for the tax period December, 1987 listed in Claim 107 is identical to that in Claim 102, therefore, it is only the FUTA tax sought for the tax period December, 1988 which the IRS seeks to amend. The FUTA tax listed in Claim 107, the amended claim, is for an identical tax period as the FUTA tax listed in Claim 102. The only difference between the FUTA tax claims is the amount. Further, the FUTA tax in Claim 107, listed as an administrative claim, does not attempt to change the character or nature of the claim. Thus,

the claim for the additional FUTA tax in Claim 107 relates to the timely filed claim sought in Claim 102 and is not a new claim. For identical reasons, this court finds that the penalty related to the FUTA tax in Claim 107 relates to Claim 102, the timely filed claim. Accordingly, with respect to the FUTA tax and the penalty related to this FUTA tax, the first prong of the test has been satisfied.

With respect to the penalties which relate to FICA claims not previously listed in a timely filed claim, this court finds that these penalties do not relate to any timely filed claim. Thus, they fail to satisfy the first prong of the test utilized in determining whether to allow an amendment to a timely filed claim. Accordingly, they will be disallowed.

Having met the first prong of the test, unless equitable considerations militate strongly against this amendment, the FUTA tax will be allowed. *McLean*, 121 B.R. at 709. The trustee asserts that, if this claim is allowed, creditors in the same class will be prejudiced because it will "reduce their dividend." (Doc. 211 at 7). In light of the policy favoring liberal amendment, see *McLean*, 121 B.R. at 710, this type of prejudice by itself, in this proceeding, is insufficient. This court finds that there is no undue prejudice to the trustee or any other claimant.

Moreover, there is justification for the failure to file a timely claim.[5] The IRS stated that Claim 102 was an estimated claim. The IRS has justified the need for the statement that the tax amounts were just an estimate because "the bar date fell before the debtor's 1988 tax return was due," and no evi-

[5] This court recognizes that the IRS's amended claim was not filed until approximately 5 months following the bar date.

dence in the record exists to dispute this assertion. (Doc. 210 at 7). Although such a statement, standing alone, might not provide justification for an untimely claim, it does provide the trustee and claimants with notice that the amounts contained in the IRS's initial claim may not be accurate and may be subsequently amended.

The trustee asserts that the proposed amended claim should not be allowed because it does not state on its face that it is an "amendment." As the very party that has strenuously argued, and has thereafter benefited from the application of equitable principles on the subordination issue, it is not particularly persuasive for the trustee to attempt to prevent the application of equitable principles on the amendment issue. This court finds that Claim 107, the amended claim, though not specifically designated an "amendment," substantively constitutes an amendment and is thus determined to be an amended claim. *See In re Pyramid Building* Co., 87 B.R. 38, 40 (Bankr. N.D. Ohio 1988). "A contrary result would clearly elevate form over substance and violate equitable considerations controlling amendments." *Id.*

Further, with respect to the penalty related to the FUTA tax, this court finds no equitable considerations militating against its allowance; however, in accordance with this court's previous discussion of equitable subordination (§ 510(c)(1)), this court subordinates this penalty to that of the general unsecured creditors.

Accordingly, this court, having initially examined the plain meaning of the applicable Code provisions, and, where appropriate, having consulted legislative history and having found no evidence of congressional intention to break with the pre-Code practice of

preferring the payment of actual losses prior to the payment of penalties, and having determined that this result is not at odds with the intention of Congress, the court concludes:

1) With respect to Claim 102:

   a) the penalties are equitably subordinated to that of the general unsecured creditors,

2) With respect to Claim 107:

   a) the FUTA tax is allowed as an amendment to the FUTA tax in Claim 102 and is allowed as an administrative expense,

   b) the penalty related to this FUTA tax is allowed; however, this penalty is equitably subordinated to that of the general unsecured creditors and

   c) the penalties which relate to the FICA claims not previously listed in a timely filed claim do not amend claims in Claim 102 and are disallowed.

An order in accordance with this decision is simultaneously entered.

SO ORDERED.

/s/ Thomas F. Waldron
THOMAS F. WALDRON
United States Bankruptcy Judge

APPENDIX F

1. Section 503, 11 U.S.C. (1988), provides in relevant part:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—

(1) • • •

(B) any tax—

(i) incurred by the estate, except a tax of a kind specified in section 507 (a)(7) of this title; or

(ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case; and

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

• • • • •

2. Section 507, 11 U.S.C., provides in relevant part:

(a) The following expenses and claims have priority in the following order:

(1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

• • • • •

3. Section 510, 11 U.S.C., provides in relevant part:

• • • • •

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

4. Section 726, 11 U.S.C., provides in relevant part:

(a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if—

(i) the creditor that holds such claim did not have notice or actual knowledge

of the case in time for timely filing of a proof of such claim under section 501 (a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

* * * * *

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